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IN THE

Supreme Court of the United States

October Term, 1962.

No. 880

THEODORE F. APPLEBY and MARIE W. APPLEBY,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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INDEX

PETITION:	PAGE
Opinions Below	2
Opinion of Tax Court	2
Opinion of Court of Appeals for the Third Circuit	2
Jurisdiction	2
Questions Presented	3
Statutes, Federal Rules, and Regulations Involved	4
Statement	4
Reasons for Granting the Writ	5
Conclusion	14

CITATIONS

CASES:

Bondy v. Commissioner of Internal Revenue, 269 Fed. 463 (C. A. 4th Cir. 1959)	9
Carter Oil Company v. McQuigg, 112 F. 2d 275 (C. A. 7th Cir. 1940)	12
Commissioner v. Coady, 33 T. C. 771., affirmed on opinion below, 289 F. 2d 490 (C. A. 6th Cir. 1961)	5, 6, 7, 8, 9, 11
Commissioner of Internal Revenue v. Spermacet Whaling & Shipping Co., S A. 281 F. 2d 646 (C. A. 6th Cir. 1960)	13

PAGE

Fackler v. Commissioner, 45 B. T. A. 708 (1941), 133 F. 2d 509 (6th Cir. 1943) 8

Heim v. Universal Pictures Company, Inc., 154 F. 2d 480 (C. A. 2d Cir. 1946) 12

Kraft Foods Co. v. Commissioner of Internal Revenue, 232 F. 2d 118 (C. A. 2d Cir. 1956) 13

Orvis v. Higgins, 180 F. 2d 537 (C. A. 2d Cir. 1950), certiorari denied 340 U. S. 810; 95 L. Ed. 595; 71 S. Ct. 37 ..... 12, 13

Pennroad Corp. v. Commissioner of Internal Revenue, 261 F. 2d 325 (C. A. 3rd Cir. 1958), certiorari denied 359 U. S. 958; 3 L. Ed 2d 766; 79 S. Ct. 797 13

Wilkins v. U. S., 188 F. Supp. 91 (S. C. Ill. 1960) 8, 9

STATUTES:

28 U. S. C. 1254(1) 2

I. R. C. of 1954, §355 ..... 4, 5, 6, 8, 9

REGULATIONS AND RULINGS:

Section 1.355-1(a) 3, 4, 6, 9

Section 1.355-1(c) 3, 4, 6, 9

CB 1960-2, 8 7

MISCELLANEOUS:

Federal Rules of Civil Practice, Rule 52(a) 3, 4, 10, 11, 12, 13, 14

Moore's Federal Practice, 2nd Ed., Vol. 5, Section 52.04 12

ARTICLES: PAGE

Divisive Reorganization, Note 67, Yale Law Journal 38 8

Lyons, some problems in corporate separations under the 1954 Code, 12 Tax Law Review 15-22 (1957) 8

Young Corporate Separations, some revenue rulings under Section 355, 71 Harvard Law Review 843 8

SUPPLEMENTAL APPENDIX:

Findings of Fact and Opinion of the Tax Court 15

Decision of the Tax Court 31

Opinion of the United States Court of Appeals for the Third Circuit 32

Internal Revenue Code of 1954, Sec. 355 34

Treasury Regulations on Income Taxes (1954 Code), Sec. 1.355-1 37

Rule 52(a)—Federal Rules of Civil Practice 40

IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1962.

No.

THEODORE F. APPLEBY and MARIE W. APPLEBY,
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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

The petitioners, Theodore F. Appleby and Marie W. Appleby, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit entered in the above case on January 10, 1962.

OPINIONS BELOW.

The opinion of the Tax Court of the United States is reported at 35 T. C. 755.

The opinion of the Court of Appeals for the Third Circuit is reported at 296 F. 2d 925.

JURISDICTION.

The judgment of the Court of Appeals for the Third Circuit was made and entered on January 10, 1962, and a copy thereof is appended to this petition in the Supplemental Appendix at p. 33. Petition for rehearing filed January 19, 1962, was denied on January 30, 1962. The jurisdiction of this Court is invoked under 28 U. S. C. 1254 (1).

QUESTIONS PRESENTED.

1. Whether the Treasury regulations Section 1.355-1(a) and Section 1.355-1(c) are valid. These regulations prohibit the divisive reorganization of a corporation under Section 355 if it is engaged in a single business or if the devisive reorganization involves an incidental business.

2. Whether the Court of Appeals may substitute its judgment for that of the Tax Court, under Rule 52(a) of the Federal Rules of Civil Practice, where the evidence is stipulated or uncontroverted and not subject to any adverse inferences.

3. Whether failure of the Appellate Court to consider the main legal issue and to set forth its conclusion of law is so violative of fundamental principles of jurisprudence as to warrant remand.

STATUTES, FEDERAL RULES, AND REGULATIONS INVOLVED.

The pertinent provisions of the Internal Revenue Code of 1954 are Section 355 and Regulation Section 1.355-1(a) & (c); Rule 52(a) of Federal Rules of Civil Procedure is also involved. These statutes, rules and regulations are set forth in the Supplemental Appendix hereto.

STATEMENT.

This case arises under Section 355 of the Internal Revenue Code of 1954. In January 1955 petitioners were the sole shareholders of the T. Frank Appleby Agency, Inc. That corporation, for valid business reasons, separated its real estate ownership activities from the real estate brokerage activities. This was accomplished by the T. Frank Appleby Agency, Inc. transferring its real property, which consisted of a building at 230 Main Street, Asbury Park, New Jersey, to a newly created corporation, the Appleby Building Corporation. The stock of the Appleby Building Corporation was distributed pro rata to the petitioners. This type of divisive reorganization is commonly referred to as a "spin-off".

The government's sole contention is that the reorganization in question does not meet the specific requirement of Section 355B(2)(b) in respect to the Appleby Building Corporation. Respondent concedes that the Appleby Building Corporation after the divisive reorganization owned and operated 230 Main Street, and was then engaged in the active conduct of a trade or business. Respondent asserts

that such trade or business had not been actively conducted throughout the five year period ending on the date of distribution. 230 Main Street had been owned and operated by the T. Frank Appleby Agency for eight years prior to the reorganization.

The dispute between petitioners and respondent is not a factual dispute. It involves the application of the facts to the correct legal principles. Petitioners contend that as a matter of law, the ownership and operation of commercial property is the active conduct of a trade or business under Section 355 of the Internal Revenue Code of 1954.

A petition for review of this case was filed with the Tax Court of the United States on June 26, 1961. The Tax Court of the United States upheld the determination of the Commissioner of Internal Revenue and a decision was entered April 7, 1961. A copy of that opinion is set forth in the Appendix at page 76a, and in the Supplemental Appendix at page 15. An appeal was taken to the United States Court of Appeals for the Third Circuit, which affirmed the Tax Court's opinion in a decision entered on January 10, 1962. On January 19, 1962, petitioners petitioned for a rehearing to the Court of Appeals for the Third Circuit, and on January 30, 1962, the petition for rehearing was denied.

REASONS FOR GRANTING THE WRIT.

I.

The decision below should be reviewed because it directly conflicts with the decision of the Court of Appeals in the case of *Commissioner v. Coady*, 33 T. C. 771, affirmed on opinion below 289 F. 2nd 490 (C. A. 6th Cir. 1961). The

Coady case was originally a decision of the full Tax Court holding that a construction company could be separated into two separate companies and that the regulation prohibiting the division of a single business, Regulation Section 1.355-1(a), was invalid. The divided activities were incidental to one another as prohibited in Reg. Section 1.355-1(c). Basically, the single business requirement and the requirement that one business not be incidental to another are identical. *A fortiori* if one can divide a single business, one can divide a business which has two activities, one being incidental to another. The basic policy question here is whether there is any reason to prohibit the vertical reorganization of corporations and whether Congress in enacting Section 355 prohibited divisive vertical reorganizations. The Tax Court decision in this case is by a single judge who dissented in the *Coady* case when it was before the Tax Court. This judge considered only the separate non-incidental real estate activity prior to the "spin-off". The Tax Court never answered the question—"If a single business can be divided into two separate businesses, why cannot this division take place if the division involves separation into real property management and the brokerage business?". The Tax Court merely erroneously assumed, "However, we are not confronted with the question of a single business being divided into two businesses" (P72a). That question is certainly presented in this case. The *Coady* case states:

> "We do not think it inevitably follows that each such trade or business necessarily must have been conducted on an individual basis throughout that five year period. As long as the trade or business which has been divided has been actively conducted for five years preceding the distribution, and the resulting businesses (each of which in this case happens to be half of the original whole) are actively conducted after the divi-

sion, we are of the opinion that the active business requirements of the statute have been complied with"

. . .

"There being no language, either in the statute or committee report, which denies tax free treatment under Section 355 to a transaction solely on the grounds that it represents an attempt to divide a single trade or business, the Commissioner's regulations which impose such a restriction are invalid, and cannot be sustained. *Commissioner v. Auker* —— U. S. —— (November 16, 1959." *Commissioner v. Coady*, supra.

There is no more common situation than a business structure involving a separate corporation for the realty enterprise and a separate corporation for the principal operating business. Legislative history clearly demonstrates that Congress intended to encourage bona fide corporate reorganizations. The decision of the Third Circuit effectively prohibits the majority of corporations from separating their realty operations even when sound business considerations make that separation advisable.

The Commissioner of Internal Revenue has nonacquiesced in the *Coady* case, CB 1960-2, and has announced in Revenue Ruling 61-198 that the Internal Revenue Service would not follow *Coady* as a precedent. The practical result is that there can be no vertical divisive reorganizations and certainly no spin-off of realty operations. Not only is the decision of the Third Circuit in conflict with the decision of the Sixth Circuit in *Coady*, but this is an important area of Federal Law which has not been resolved by the Supreme Court. The magnitude of realty operations involved and the enormous number of vertically integrated companies involved makes the importance of this tax question difficult to exaggerate. The tremendous tax burden imposed in a divisive reorganization which fails to qualify

under Section 355, in practice deters all legitimate bona fide divisive reorganizations in this area until the Supreme Court determines the validity of the regulations. The importance of this area is best illustrated by the volume of law review articles from our leading law schools *E.g. Divisive Reorganization*, Note 67, *Yale Law Journal*, 38; *Young Corporate Separations*, some revenue rulings under Section 355, 71 *Harvard Law Review*, 843; *Lyons*, some problems in corporate separations under the 1954 Code, 12 *Tax Law Review*, 15-22 (1957). The questions presented by this case are in recurring significance in the administration of the Internal Revenue Code.

The decision of the Tax Court and the decision of the Court of Appeals affirming the Tax Court, have both relied on an erroneous legal premise in analyzing the case at bar. Respondent concedes as he must that the ownership and operation of 230 Main Street by the Appleby Building Corporation after the reorganization was the active conduct of a trade or business, *Wilkins v. U. S.*, 188 F. Supp. 91 (S. D. Ill.) (1960); *Fackler v. Commissioner*, 45 B. T. A. 708 (1941), 133 A. 2d 509 (6th Cir. 1943). Since the T. Frank Appleby Agency, Inc. for more than five years had performed the very same activities in respect to the ownership and operation of 230 Main Street, it necessarily follows that the T. Frank Appleby Agency, Inc. was, according to the definition, also engaged in the active conduct of that trade or business for the full five year period. The statute requires that the Appleby Building Corporation be engaged in the active conduct of a business after the reorganization. To constitute active conduct section 355B(2)(b) requires that "such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution." Since this section clearly presupposes a newly created corporation, it cannot refer to the corporate vehicle, nor does it require a separate, independent operation. *Com-*

missioner v. Coady, 33 T. C. 771 (1960), affirmed on opinion below 289 F. 2d 490 (C. A. 6th Cir. 1961).

Respondent cites Regulation Section 1.355-1 (c) which defines active business so as to exclude activities which were previously incidental. The Tax Court found that "the agency's management of its 230 Main Street property prior to conveying it in January 1955, to its Building Corporation, was incidental to the operation of its real estate and insurance business." The Tax Court had previously held and been affirmed by the Sixth Circuit that a single business can be divided under Section 355. These decisions correctly invalidated Treasury regulations which attempted to prohibit the division of a single business. Since the Sixth Circuit has held the regulations invalid and held that a single business can be divided into two parts, there exists a basic lack of logic in denying the right of two businesses to be divided into separate corporate entities, because one phase of the operation was incidental to the other.

The courts below considered only whether the portion of the building rented to outside tenants constituted a sufficient operation to be considered an active trade or business under Section 355. This presupposes a requirement of a separate activity or a non-incidental activity. One cannot read the *Coady* case, supra, without concluding that the Sixth Circuit correctly ruled that regulations purporting to create this requirement are invalid. The basic error for which review is requested involves why the entire building's ownership and operation should not have been considered rather than merely the separate outside rentals. Ownership and operation of real property is the active conduct of a trade or business even if wholly owner occupied. *Bondy v. Commissioner*, 269 F. 2d 463 (C. A. 4th Cir. 1959); *Wilkins v. U. S.*, supra. If Regulation Section 355 (1) (a) and (1) (c) is invalid, and the Sixth Circuit and Tax Court have both so held, then the correct legal analysis

compelled the Court of Appeals for the Third Circuit to consider whether the ownership and operation of the entire building constituted an active trade or business. That this is so is well settled law and cannot seriously be contested.

The case law and the concessions of the government below, demonstrated there is no real legal dispute that the ownership and operation of a building such as 230 Main Street, constitutes the active conduct of a trade or business. Despite the affirmation of the Tax Court's factual conclusions, the Court of Appeals should have declared the regulations invalid and reversed the Tax Court's decision.

II.

RULE 52a—RULES OF FEDERAL PRACTICE.

The Third Circuit, in affirming the Tax Court's decision, believed it could not reverse the court below unless the findings were clearly erroneous. Under Rule 52(a) as the rules of Federal Practice are commonly interpreted, the Court of Appeals should have felt free to substitute its own judgment on this finding of ultimate fact. This certainly is true in view of the ability of the Court of Appeals to equally evaluate the evidence. All the findings of the Tax Court are undisputed other than the ultimate conclusion that one particular group of activities can be characterized as incidental to another. Rule 52(a) was further violated in that the Court of Appeals did not set forth its conclusions of law. Petitioners contend that the regulations are invalid and that it is immaterial whether or not the outside rentals were incidental to the brokerage business prior to the reorganization. The opinion below merely affirms the Tax Court's findings that these activities were incidental to the brokerage business. Its failure to set

forth the conclusions of law as to the validity of the regulations and the application of the legal principles involved have led the Court below into error in not considering whether the entire building operations were the active conduct of a trade or business. It has further prejudiced petitioners' rights to petition for certiorari. Petitioners have no right to a writ of certiorari, but they have a right to petition for a writ of certiorari and a right under Rule 52(a), of the Federal Rules of Civil Practice, that the Appellate Court set forth its conclusions of law so that petitioners, when applying for a writ of certiorari, need only to refer to the conclusions in the opinion below.

This is particularly true where the petitioners have properly raised below the question of the validity of the controlling treasury regulations. Certainly, petitioners' rights should not be prejudiced by this departure from settled judicial procedure. Petitioners have always believed that if any Court would attempt to distinguish this case from the *Coady* case or explain to petitioners any legal basis for this decision, that that Court would fail so clearly that it would be compelled to find for petitioners. Petitioners face a harsh confiscatory tax burden without even the fundamental due process of being told the legal basis for the decision.

The Court below in its opinion of affirmance finds that, "while the Tax Court decision could have gone the other way, there is ample evidence in the record to support it; certainly, we cannot say it is clearly wrong". The Tax Court did not set forth its conclusion of law as to the validity of the challenged regulations. The Third Circuit did not set forth its decision on the validity of the regulations. The factual conclusion rested on these regulations, which regulations were declared invalid in *Coady*. Petitioners' Petition for Rehearing on January 19, 1962, requested again that the Court set forth its conclusion as to the validity of the regulations; a question which was properly before it and re-

quired to be decided under fundamental principles of Appellate Review. Petition for rehearing was denied. On what legal basis does this decision rest? That is the question. There is no dispute as to the facts and the evidence and an affirmance purporting to be on this basis makes no sense whatsoever.

The Third Circuit in its opinion of affirmance finds that, "certainly, we cannot say it is clearly wrong". The evidential facts in this case were not in dispute. The testimony involved was that of the President of the T. Frank Appleby Agency, Inc., who gave the history of the building involved and testified in substance that the activity normally associated with the ownership and operation of a commercial property was undertaken in this case. The basic finding of the Tax Court was that there were not two separate trades or businesses; that is, the Tax Court found that the real estate operation was incidental to the brokerage and insurance business. Appeals from the Tax Court are, of course, reviewable in the same manner as appeals from the District Court without a jury. The question of the interpretation of Rule 52(a) of the rules of Federal Practice is a question of substantial Federal importance and involves not only conflicting cases between the Circuits but also decisions within a Circuit that are often in conflict. Professor James W. Moore, famous treatise; *Moore's Federal Practice*, 2nd Edition, in Volume 5, Section 52.04, therein points out the conflict between *Carter Oil Company v. McQuig*, 112 F. 2d 275 (C. A. 7th Cir. 1940) and *Heim v. Universal Pictures Company, Inc.*, 154 F. 2d 480, 491 (C. A. 2d Cir. 1946). It is further pointed out by Professor Moore that Judge Frank in *Orvis v. Higgins*, 180 F. 2d 537, 538 (C. A. 2d Cir. 1950), certiorari denied (1950) 340 U. S. 810, 95 L. Ed. 595, 71 Supreme Ct. 37, interpreted the rule to vary with the character of the evidence and where the evidence is partly oral and the balance is written and deals

with undisputed facts then the Court of Appeals may ignore the trial judge's findings and substitute its own. This is completely different from the Court of Appeals for the Third Circuit's opinion in this case which states that "While the Tax Court decision could have gone the other way, there is ample evidence in the record to support it; certainly, we cannot say it is clearly wrong". It is submitted that the proper scope of review in this case should have been for the Court of Appeals for the Third Circuit to determine whether or not on the stipulated, and uncontroverted facts below, the case should have gone the other way. The Third Circuit was in an equally advantageous position to determine whether or not the ownership and operation of a building, 50% by space and approximately 1/3 by value, was or was not an activity incidental to the brokerage and insurance business. The Court in *Penmroad Corp. v. Commissioner of Internal Revenue*, 261 F. 2d 325 (C. A. 3rd Cir. 1958), certiorari denied 359 U. S. 958 3 L. Ed. 2d 766; 79 S. Ct. 797, held that ultimate facts are subject to review free of the restraining influence of the clearly erroneous rule. The Court of Appeals for the Second Circuit in *Kraft Foods Co. v. Commissioner of Internal Revenue*, 232 F. 2d 118 (C. A. 2d Cir. 1956), held that where the facts evidenced before the Tax Court consisted of stipulated facts, the Court of Appeals was free to draw its own conclusions, but see *Commissioner of Internal Revenue v. Spermacet Whaling & Shipping Co.*, S. A. 281 F. 2d 646 (C. A. 6th Cir. 1960), stating that ultimate facts drawn from undisputed subsidiary facts are finding of fact and not to be set aside unless clearly erroneous. It has been 12 years since *Orris v. Higgins*, supra, and while Judge Frank's opinion has, as predicted by Professor Moore, commended itself to many other circuits, it is apparent that Judge Clark's view of Rule 52(a) has been adopted by other Courts. It would appear timely and important that the conflicting interpretations of

Rule 52(a) be resolved. Of course, petitioners feel strongly that the regulations are invalid and that it is immaterial whether there were separate rentals or incidental rentals. But assuming such a requirement the Third Circuit should have felt free to reach its own conclusions.

CONCLUSION.

For the reasons set forth above, it is respectfully submitted that this petition for a writ of certiorari should be granted.

DURAND, IVINS & CARTON,
By ROBERT V. CARTON,
Attorneys for Petitioners.

SUPPLEMENTAL APPENDIX.

FINDINGS OF FACT AND OPINION OF THE TAX COURT.

(Filed Feb. 16, 1961.)

The petitioner, Theodore F. Appleby, and his father, prior to 1922, operated an insurance and real estate brokerage business at a certain location. In 1922 they acquired the property and erected the present two story building, renting to five tenants that portion of the building they did not use. In 1932 the business was incorporated under the name of T. Frank Appleby Agency, Inc., and petitioners have since been its only shareholders. In 1947, the Agency acquired title to the property and occupied space on both floors of the building and rented the other floor space to tenants. By 1954 it was using approximately 50 percent of the total floor space and renting the balance to four tenants. In January 1955, the Agency caused the Appleby Building Corporation to be organized, transferred to it its property for the Building Corporation's no par value capital stock and distributed all the shares to petitioners. *Held*, that under the facts, the distribution of the stock did not qualify as a tax-free distribution under section 355 of the Internal Revenue Code of 1954.

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(2) ROBERT V. CARTON, Esq., for the petitioners.
SHELDON SEEVAK, Esq., for the respondent.

The respondent has determined a deficiency in income tax against the petitioners for the calendar year 1955, in the amount of $43,099.11. The question to be decided is whether

the distribution of the stock of the Appleby Building Corporation by the T. Frank Appleby Agency, Inc., to the petitioners in January 1955, was a dividend includible in their gross income or, whether it qualified under section 355 of the Internal Revenue Code of 1954 as a distribution on which no gain or loss is recognized.

FINDINGS OF FACT.

Some of the evidence and some of the facts have been stipulated and the facts stipulated are found as stipulated.

Petitioners are husband and wife and are residents of West Allenhurst, New Jersey. They filed a joint income tax return for the taxable year 1955 with the district director of internal revenue at Camden, New Jersey.

T. Frank Appleby Agency, Inc., hereafter sometimes referred to as the Agency, is a New Jersey corporation and since 1932 has been engaged in the business of real estate brokerage and insurance brokerage. All of its stock is owned by the petitioners.

Since 1932 the Agency has occupied a portion of a building located at the intersection of Main Street and Mattison Avenue, Asbury Park, New Jersey, usually known as 230 Main Street. Sometimes the property is (3) referred to as 730 Mattison Avenue. Hereafter it will sometimes be referred to as the 230 Main Street property.

The father of petitioner Theodore F. Appleby had rented a frame building at the same location from 1885 until 1922 when the Applebys acquired the property from an estate and erected the present building, a two-story, hollow-tile building. A small portion of the ground floor was used by the Applebys in the operation of their business and the balance of the building was rented to 5 tenants. The main part of the ground floor was rented to a restaurant. Two small

stores were rented to a tailor and a barber, and a dentist and a credit bureau rented space on the second floor. The Agency acquired title to the property in 1947. During the years 1950 through 1954, the Agency occupied approximately 50 percent of the floor space of the building, consisting of space on both the ground floor and the second floor. During 1950 through 1954 one of the tenants was a tailor by the name of Stefanile. During 1950, 1951 and 1952, another tenant was one "Major," unidentified but probably a barber, as Gentile, a barber, was a tenant during 1953 and 1954. Ripley Stores, "cleaners, launderers, tailors," rented ground floor space, facing on Main Street during the period of 1950 through 1954. The credit bureau and Samuel Bennett, a dentist, rented space on the second floor during that five-year period.

The Agency executed the leases to the tenants, had repairs made to the building, looked after the tax ratals and appeals and watched the occupancy and use of the property so that insurance rates would not be affected.

(4) At a meeting of the board of directors on November 22, 1954, a proposed plan of reorganization of the Agency was approved. A purpose of the reorganization was to segregate the ownership of real estate from the real estate brokerage and insurance brokerage activities carried on by the Agency and to expand this ownership operation in the new corporation by the purchase or construction by it of additional rental real estate.

At a special meeting of the Agency's stockholders on December 20, 1954, the plan of reorganization was approved.

In January 1955, the Appleby Building Corporation, sometimes hereafter referred to as the Building Corporation, was incorporated under the laws of the State of New Jersey.

In January 1955, the Agency transferred its 230 Main Street property to the Building Corporation in exchange for 750 shares of the latter's no par value capital stock and im-

mediately distributed such stock to petitioners in proportion to their stockholdings in the Agency. The 750 shares of the Building Corporation represented 100 percent of the outstanding stock of that corporation, and their fair market value at the time of distribution was $50,400 and not $75,000, as determined by respondent in the notice of deficiency. At the date of distribution the Building Corporation's sole asset was the 230 Main Street property. In December 1955, it acquired the land and building at 500 Grand Avenue, Asbury Park, subject to a lease to the New Jersey Bell Telephone Company and it subsequently continued to lease the building to the telephone company.

(5) On January 2, 1955, the Building Corporation and the Agency executed a lease which provided in part as follows:

> THIS INDENTURE, MADE THE 2nd day of January A. D. Nineteen Hundred and Fifty-five.
>
> BETWEEN APPLEBY BUILDING CORPORATION of the City of Asbury Park State of New Jersey of the first part and T. FRANK APPLEBY AGENCY, Inc. of the City of Asbury Park State of New Jersey of the second part
>
> WITNESSETH, That the said party of the first part, (by T. Frank Appleby Agency Inc., Main Street and Mattison Avenue, Asbury Park, N. J.) have let and by these presents do grant, demise and let unto the said party of the second part, and the said part[y] of the second part ha[s] hereby hired and taken from the said part[y] of the first part.
>
> ALL THAT ENTIRE BUILDING KNOWN AS No. 230 MAIN STREET, ASBURY PARK, N. J. and No. 730 MATTISON AVENUE, ASBURY PARK, N. J. from JANUARY 1, 1955 to JANUARY 1, 1965 at the

rent or sum of ONE HUNDRED TWENTY THOUSAND DOLLARS ($120,000.00) to be paid as follows: $12,000.00 Annually—payable—$1,000.00 on the first day of February and every month thereafter, to expiration.

Provided, that if any portion of the said premises not occupied by the party of the second part for use in its insurance and real estate business is leased to another person or persons by the party of the first part, then the party of the second part has the right to collect the rents due from the said other person or persons and apply same as a reduction of its annual rental of $12,000.00.

The Agency further agreed "to pay the said rent in the proportions and upon the conditions aforesaid"; that, "at the expiration of said term, to yield up and surrender the possession thereof, with the appurtenances, in as good state and condition as the same now are, or may be put into by the said part[y] of the first part, reasonable wear and tear and accidents happening by fire or other casualties excepted"; and that the Agency "shall pay for all gas and electric current consumed, and telephone bills, repair or replace all articles that may be lost, broken or damaged."

(6) The lease was signed by Theodore F. Appleby, as president, of each corporate party.

The fair rental value of the property in its entirety is approximately $12,000 per annum.

After the reorganization in January 1955, the Building Corporation owned and operated the 230 Main Street property. The Agency continued its real estate and insurance business and continued to occupy approximately 50 percent

of the floor space of the building, using space on both floors. Besides the agency, there were four other tenants or space available to four tenants. The Building Corporation set up its bank account, its system of bookkeeping, took complaints, drew up leases, checked records and looked after insurance rates. It had two employees, petitioner Theodore F. Appleby, its president, who was paid $1,500 a year, and one of the Agency's employees who was assigned to "that building" and was paid $62.50 a week. The Agency's office was used by the Building Corporation.

Prior to conveying the property in January 1955, the Agency had received gross income from the portions rented to tenants for the years 1950, 1951, 1952, 1953 and 1954 as follows:

	1950	1951	1952	1953	1954	Total
Stefanile	$ 725.00	$ 630.00	$ 890.00	$ 330.00	$ ..	$ 2,575.00
Ripley Stores	1,800.00	1,800.00	1,800.00	1,800.00	1,650.00	8,850.00
Retail Credit	512.50	540.00	690.00	660.00	720.00	3,122.50
Bennett	422.50	551.00	552.50	510.00	425.00	2,461.00
Major	240.00	240.00	130.00	...	..	610.00
Gentile				300.00	720.00	1,020.00
	$3,700.00	$3,761.00	$4,062.50	$3,600.00	$3,515.00	$18,638.50

(7) During the same period of time the Agency's gross rental income, gross income from all source and net income were as follows:

Year	Gross Rental Income	Gross Income All Sources	Net Income
1950	$3,700.00	$ 88,507.95	$ 5,114.72
1951	3,761.00	108,322.03	12,140.30
1952	4,062.50	103,301.23	6,007.92
1953	3,600.00	115,686.84	8,224.30
1954	3,515.00	163,264.17	38,046.53

Petitioners received salaries from the Agency during the same period of time, as follows:

Year	Theodore F. Appleby	Marie W. Appleby
1950	$15,600.00	$3,600.00
1951	19,000.00	3,600.00
1952	19,000.00	3,600.00
1953	23,250.00	3,600.00
1954	30,000.00	5,200.00

During the same years the Agency incurred expenses with the 230 Main Street property as follows:

	1950	1951	1952	1953	1954
Property Taxes	$1,532.85	$1,609.09	$1,790.48	$1,848.92	$2,028.00
Insurance	1,026.66	1,045.85	1,114.98	1,304.30	1,036.70
Maintenance & Supplies	1,611.68	3,286.05	1,051.70	614.81	1,654.97
Janitor Service	954.00	1,056.00	1,112.50	1,112.50	1,132.50
Depreciation	1,128.66	1,128.66	1,128.66	1,128.66	1,128.66
Interest on Mortgage	1,039.29	970.66	775.15	707.79	531.62
Heating Oil & Repairs	432.27	362.91	402.51	387.12	553.01
Totals:	$7,725.41	$9,459.22	$7,375.98	$7,104.10	$8,115.46

The undistributed earnings and profits of the Agency as of December 1, 1955, were $72,315.74.

(8) Prior to 1948, in addition to the 230 Main Street property, the Agency owned and occupied a frame building at Main Street, Allenhurst, New Jersey. The building was destroyed by fire in 1948 and the lots were sold in 1948 and 1949 at a profit. In April 1944, the Agency purchased a small hotel property in Asbury Park which it leased to a tenant. This property was sold in 1945 at a profit.

The Agency's management of its 230 Main Street property prior to conveying it in January 1955 to its Building Corporation was incidental to the operation of its real estate and insurance brokerage business.

OPINION.

TURNER, Judge: The only issue is whether the distribution by the Agency of all the stock of its wholly-owned subsidiary, the Building Corporation, to its stockholders, the petitioners, qualifies as a non-taxable distribution under section 355 of the Internal Revenue Code of 1954.[1]

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[1] SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) Effect on Distributees.—

(1) General rule.—If—

"(A) a corporation (referred to in this section as the 'distributing corporation')—

(i) distributes to a shareholder, with respect to its stock, . . .

. . . . . .

solely stock or securities of a corporation (referred to in this section as 'controlled corporation') which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both . . .

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(9) Section 355 (a), in so far as applicable here, provides that (1) if a corporation distributes to its shareholders with respect to their stock, solely stock of a corporation which it controlled immediately (10) before the distribution, (2) the transaction was not used principally as a device for distributing the earnings or profits of either corporation, (3) the requirements of subsection (b) with reference to active conduct of businesses are satisfied and (4) all of the stock of the controlled corporation held by the distributing cor-

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(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities of the controlled corporation held by it immediately before the distribution, * * *

* * * * * * *

then no gain or loss shall be recognized to and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

* * * * * * * * *

(b) Requirements as to Active Business.—

(1) In General.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation * * * is engaged immediately after the distribution in the active conduct of a trade or business, * * *

* * * * * * *

(2) Definition.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, * * *

(B) such trade or business has been actively conducted throughout the 5 year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at any time) after acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

poration is distributed, then no gain or loss shall be recognized to the shareholders on receipt of the stock.

Petitioners contend that all the above requirements have been met and respondent contends that neither corporation was actively engaged in the conduct of the business of property management or the renting of real estate throughout the five-year period ending on the date of distribution within the meaning of section 355.

The evidence shows that the father of Theodore F. Appleby established the real estate brokerage and the insurance brokerage business in 1885 at the site that now is 230 Main Street in Asbury Park; that at some undetermined date Theodore became engaged in the business with his father; that together they acquired the 230 Main Street property in 1922; that they erected the present building, a small part of which they used for their business and the remaining space was rented to various tenants; that in 1932 the business was incorporated under the name of T. Frank Appleby Agency, Inc., with petitioners owning all the stock; that the business of the Agency was carried on in the building until January 1955; that it acquired title to the property in 1947; that its business grew and expanded to where it needed and occupied more space; that at some undetermined time it occupied space on both floors of the building to (11) the extent of 50 percent of the total floor area; that the Agency continued to rent space to tenants, there being five during the years 1950 through 1953 and four in 1954 and 1955; that the gross rental received by the Agency during the five-year period, 1950 through 1954, was $3,700 in 1950, $3,761 in 1951, $4,062.50 in 1952, $3,600 in 1953, and $3,515 in 1954; that its gross income from all sources was $88,507.95 in 1950, $108,322.03 in 1951, $103,301.23 in 1952, $115,686.84 in 1953, and $163,264.17 in 1954; that the Agency incurred expenses in connection with the property, covering property taxes, insurance, maintenance and supplies, janitor service,

heating oil and repairs, depreciation and interest on mortgage, amounting to $7,725.41 in 1950, $9,459.22 in 1951, $7,375.98 in 1952, $7,104.10 in 1953, and $8,115.46 in 1954.

The evidence also shows that no records were maintained as to the net income of the rentals; that the net income of the Agency for the five year period was $5,114.72 in 1950, $12,140.30 in 1951, $6,007.92 in 1952, $8,224.30 in 1953, and $38,046.53 in 1954; that during the same period Theodore and Marie received salaries in the respective amounts of $15,600 and $3,600 in 1950, $19,000 and $3,600 in 1951, $19,000 and $3,600 in 1952, $23,250 and $3,600 in 1953, and $30,000 and $5,200 in 1954.

It is further shown that in January 1955 the Agency caused the Building Corporation to be incorporated; that it transferred its only asset, the 230 Main Street property, to the new corporation in exchange for all the 750 shares of no par value capital stock and immediately distributed the stock to the petitioners; that thereupon the Building (12) Corporation owned and operated the property; that at the same time the Agency and the Building Corporation executed a lease under which the entire building was rented to the Agency for the annual rental of $12,000, with a provision that any other rentals received would be applied on the Agency's rental; that the fair market value of the 750 shares of stock distributed was $50,400 and that as of December 31, 1955, the Agency had undistributed earnings and profits in the amount of $72,315.74.

Patently, the Building Corporation in January 1955, when it was created, when it received the 230 Main Street property and when its stock was distributed to petitioners, had not been engaged in the active conduct of a business for five years prior to the distribution of its stock. On the other hand, it is obvious that at the time of the transaction the Agency, the controlling and distributing corporation, had been engaged during the five-year period in the conduct of

an active trade or business, but was it engaged in the active business of property management or the rental of real estate for which business its subsidiary, the Building Corporation, was created?

Under the original regulation (section 1.355-1(a)), section 355 was made applicable to divisions of only those corporations which had conducted two or more separate and distinct businesses for a five-year period and that "[s]ection 355 does not apply to the division of a single business." However, a majority of this Court held that that part of the regulation was invalid and that there was nothing in the statute that prevented the section from applying to the division of a (13) single business into two separate businesses, where such business had been actively conducted over the required five-year period of time. *Edmund P. Coady*, 33 T. C. 771.

However, we are not confronted with the question of a single business being divided into two businesses. To the contrary, petitioners contend that the Agency was engaged in the active conduct of the business of renting real estate or property management as well as conducting the real estate brokerage and insurance brokerage business; and that the Building Corporation was organized for the purpose of operating the rental of its real estate.

Subsection (c) of the above-mentioned regulation (section 1.355-1) describes "Active business" as follows:

> Section 355 is not applicable unless the controlled corporation and the distributing corporation are each engaged in the active conduct of a trade or business. For specific rules in this connection see section 355(b)(1) and (2). Without regard to such rules, for purposes of section 355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such

group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses. It does not include—

(1) The holding for investment purposes of stock, securities, land or other property, including casual sales thereof (whether or not the proceeds of such sales are reinvested).

(2) The ownership and operation of land or buildings all or substantially all of which are used and occupied by the owners in the operation of a trade or business, or

(3) A group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.

(14) Several examples are set forth in the regulation that illustrate the application of the above-described rules, two of which are as follows:

Example (3). Corporation C, a bank, owns an eleven-story downtown office building, the ground floor of which is occupied by it in the conduct of its banking business and the remaining ten floors of which it rents to various tenants. The ten floors are rented, managed and maintained by the real estate department of the bank. It is proposed to transfer the building to a new corporation and distribute the stock of such new corporation to the bank's shareholders. The activities in connection with banking constitute a trade or business as do also the activities in connection with the rental of the building.

> Example (4). Corporation D, a bank, owns a two-story building in a suburban area, the ground floor and approximately one-half of the second floor of which is occupied by it in the conduct of its banking business. The remainder of the second floor is rented as storage space to a neighboring retail merchant. It is proposed to transfer the building to a new corporation and distribute the stock of such new corporation to the bank's shareholders. With respect to the rental of part of the second floor of its building, the bank is not engaged in the active conduct of a trade or business, such activity being only incidental to its banking business.

While the facts in the instant case do not fall exactly within either example, Example No. 4 is more applicable than Example No. 3.

Example No. 4 was followed and upheld by this Court in *Isabel A. Elliott*, 32 T. C. 283. There Centrifix Corporation bought an old house in 1946, occupying about half of it in its business and renting the remainder of it to others until it was sold in 1950, at which time it bought a larger building. Title to the new building was immediately transferred to a newly formed corporation, Centrifix Management Corporation, in April 1950. Management rented about half the space in the new building to Centrifix and held the rest for rental to others. On December 15, 1954, Centrifix distributed all the stock of Management to Elliott, its principal stockholder, in exchange for all of Centrifix's (15) issued preferred stock. The Court held that the distribution of stock to Elliott did not qualify as a tax-free distribution under section 355 since Centrifix was not actively conducting a real estate rental business prior to April of 1950.

In the instant case we have a similar situation. Prior to distribution of the stock the building in principal part was utilized by the Agency for the conduct of its business. On

a square footage basis the space occupied was approximately 50 percent of the floor space of the building but was 70 percent of the rental value. The renting of the space the Agency did not use in the conduct of its other business was incidental and that is shown by the small activity exerted, the small amount collected in rentals as compared to the total income received from all sources and the lack of records maintained to show profits or losses from the operation of a rental business. As stated in the opinion of the *Elliott* case, *supra*, "[W]e do not think a mere passive receipt of income from the use of property which is used in the principal trade or business and which is only incidental to, or an incidental use of a part of property used primarily in, the principal business would constitute the active conduct of a trade or business within the meaning of section 355 (b) of the Code, whether or not such use of property might constitute a trade or business within the meaning of other sections of the Code."

(16) Petitioner's references to such cases as *John D. Fackler*, 45 B. T. A. 708, affd. 135 F. 2d 509, and *Leland Hazard*, 7 T. C. 372, are not appropriate in the application of section 355.

Respondent is sustained.

Decision will be entered under Rule 50.

DECISION.

Pursuant to the Findings of Fact and Opinion of the Court filed February 16, 1961, the parties on March 30, 1961, having filed an agreed computation of the tax involved, it is

ORDERED and DECIDED: That there is a deficiency in income tax for the taxable year 1955 in the amount of $28,385.05.

(Signed) BOLON B. TURNER,
Judge.

Entered April 7, 1961.

OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

UNITED STATES COURT OF APPEALS.
FOR THE THIRD CIRCUIT.

No. 13,690.

THEODORE F. APPLEBY and MARIE W. APPLEBY,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES.

Argued December 22, 1961.

Before McLAUGHLIN, KALODNER and HASTIE, Circuit Judges.

OPINION OF THE COURT.

(Filed January 10, 1962.)

PER CURIAM.

The decisive fact issue here is whether petitioners have met the "active business" requirement of Section 355 of the Internal Revenue Code of 1954 so as to have the distribution of the stock of the wholly owned subsidiary qualify as a non-taxable distribution. While the Tax Court decision could have gone the other way there is ample evidence in the record to support it; certainly we cannot say that it is clearly wrong.

The decision of the Tax Court will be affirmed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

INTERNAL REVENUE CODE AND TREASURY REGULATION

Internal Revenue Code of 1954:

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) *Effect on Distributees.*—

(1) *General rule.*—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholders, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the con-

trolled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) *Non pro rata distributions, etc.*—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) *Limitation.*—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356

as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) *Cross reference.*—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) *Requirements as to Active Business.*—

(1) *In general.*—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such Corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) *Definition.*—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade of business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by

it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

(26 U. S. C. 1958 ed., Sec. 355.)

Treasury Regulations on Income Taxes (1954 Code):

Sec. 1.355-1. *Distribution of Stock and Securities of Controlled Corporations*—(a) *Application of section.* Section 355 provides for the separation, without recognition of gain or loss to the shareholders and security holders, of two or more existing businesses formerly operated, directly or indirectly, by a single corporation. It applies only to the separation of existing businesses which have been in active operation for at least five

years, and which, in general, have been owned for at least five years by the corporation making the distribution of stock or of stock and securities. Section 355 does not apply to the division of a single business. For the purpose of section 355, stock rights or stock warrants are not included in the term "stock and securities."

(b) *Type of separations.* Section 355 is concerned with two general types of separations of businesses. The first is the distribution of the stock of an existing corporation. The second is the distribution of the stock of a new corporation which stock was received in exchange for the assets of a business previouly operated by the distributing corporation. In both cases, this section contemplates the continued operation of the businesses existing prior to the separation.

(c) *Active business.* Section 355 is not applicable unless the controlled corporation and the distributing corporation are each engaged in the active conduct of a trade or business. For specific rules in this connection see section 355(b)(1) and (2). Without regard to such rules, for purposes of section 355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses. It does not include—

(1) The holding for investment purposes of stock, securities, land or other property, including casual sales thereof (whether or not the proceeds of such sales are reinvested),

(2) The ownership and operation of land or buildings all or substantially all of which are used and occupied by the owner in the operation of a trade or business, or

(3) A group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.

(d) The following examples illustrate the application of the rules described in paragraph (c) of this section:

Example (1). Corporation A is engaged in the manufacture and sale of soap and detergents and owns investment securities. It proposes to place the investment securities in a new corporation and distribute the stock of such new corporation to its shareholders. The holding of investment securities does not constitute a trade or business.

Example (2). Corporation B is engaged in the business of manufacturing and selling hats in its own factory building. It proposes to transfer the factory building to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in connection with the manufacturing of hats constitute a trade or business; but the operation of the factory building does not.

Example (3). Corporation C, a bank owns an eleven-story downtown office building, the ground floor of which is occupied by it in the conduct of its banking business and the remaining ten floors of which it rents to various tenants. The ten floors are rented, managed and maintained by the real estate department of the bank. It is proposed to

transfer the building to a new corporation and distribute the stock of such new corporation to the bank's shareholders. The activities in connection with banking constitute a trade or business as do also the activities in connection with the rental of the building.

Example (4). Corporation D, a bank, owns a two-story building in a suburban area, the ground floor and approximately one-half of the second floor of which is occupied by it in the conduct of its banking business. The remainder of the second floor is rented as storage space to a neighboring retail merchant. It is proposed to transfer the building to a new corporation and distribute the stock of such new corporation to the bank's shareholders. With respect to the rental of part of the second floor of its building, the bank is not engaged in the active conduct of a trade or business, such activity being only incidental to its banking business.

* * * * * * * * * *

Rule 52(a).

Findings by the Court.

EFFECT. In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon and direct the entry of the appropriate judgment; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests

for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court. If an opinion or memorandum of decision is filed, it will be sufficient if the findings of fact and conclusions of law appear therein. Findings of fact and conclusions of law are unnecessary on decisions of motions under Rules 12 or 56 or any other motion except as provided in Rule 41(b).